No. 16004

United States Court of Appeals
for the Ninth Circuit

THE IDAHO FIRST NATIONAL BANK, *Appellant,*

vs.

UNITED STATES OF AMERICA, *Appellee.*

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF IDAHO,
SOUTHERN DIVISION

HONORABLE WILLIAM HEALY, *Acting District Judge*

BRIEF OF AMICI CURIAE

HOWE, DAVIS, RIESE & JONES
JOHN M. DAVIS and
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BRIEF OF AMICI CURIAE

I. INTEREST OF AMICI CURIAE

Pursuant to leave of this court heretofore granted under date of August 18, 1958, and consented to by the parties to this appeal, the writers of this brief join with the Appellant in urging that the decision of the lower court be reversed.

The writers of this brief represent Miners & Merchants Bank of Chelan, Washington, which was placed in voluntary liquidation on January 31, 1953, and whose assets were distributed to its stockholders immediately after it was placed in voluntary liquidation. This bank was a cash basis taxpayer and at the time of its liquidation held certain notes and obligations upon which there was accrued interest. The Commissioner of Internal Revenue has taken the position that this accrued interest was includable in the income of Miners & Merchants Bank during its final taxable year and the bank has contested this position. The issue raised by this contest

is identical with that raised in the present appeal and the ultimate determination of this issue will undoubtedly turn upon the outcome of this appeal. These facts are the basis of the interest of the writers of this brief in urging the reversal of the decision of the lower court.

II. ARGUMENT

A. Argument in Support of Reversal of Decision of Lower Court.

1. Wendell National Bank had a right to report its income on the "cash basis" and this method of accounting clearly and accurately reflected the income of the bank.

Wendell National Bank (hereinafter called "Wendell Bank") had the right and was required under the Internal Revenue Acts, Regulations and Decisions to report its income for income tax purposes on the "cash basis" or on the "accrual basis." *Huntington Securities Corporation v. Busey,* 112 F.(2d) 368 (6th Cir., 1940), particularly at page 370. The bank chose to report its income for tax purposes on the "cash basis" which means on a cash receipts and disbursements method of accounting (Tr. 18, 25). Under this method of accounting, all items of gross income are included in the taxable year in which they are received by the taxpayer (or are constructively received in certain instances), and deductions are taken in the year in which they are paid by the taxpayer. Accrued interest is not includable in income of a cash basis taxpayer either on unmatured or past due obligations. See U.S. Treasury Regulation 111, Sec. 29.41-2. The right of Wendell Bank to have

selected the cash basis for reporting its income for tax purposes is further emphasized by the fact that the Commissioner of Internal Revenue at no time questioned the basis selected by it. In fact, when the final income tax return of the Wendell Bank, for the period ending May 10, 1952, was filed on the "accrual basis," the Commissioner upon first examining the return eliminated accrued interest from the income of the Wendell Bank on the ground that the Wendell Bank, a cash basis taxpayer, erroneously included accrued interest as "income" (Tr. 19, 20, 26, 27).

In pursuing the cash basis for reporting for income tax purposes, the Wendell Bank did not include as "income" any obligations to it for interest, whether due and payable or not yet due and payable, at the close of any taxable year.

Once having selected the cash basis of accounting for income tax purposes, the Wendell Bank is required to use that same basis consistently, year after year, and will not be permitted to change to the "accrual basis," except upon receiving the consent of the Commissioner. U.S. Treasury Regulation 111, Sec. 29.41-2. Thus, in the first instance, the Wendell Bank is required to file its final tax return on the same basis on which it has filed all prior returns, namely, the cash basis. It is the position of the Appellant that such cash basis of accounting clearly reflected income, within the requirement of 26 U.S.C.A. (Internal Revenue Code, 1939) Sec. 41, relating to accounting period and methods.

2. In the event the Commissioner could change the method of accounting of the Wendell Bank, he must change it to a recognized "method" of accounting and not to the distorted method of accounting adopted by the Commissioner in this case.

The Commissioner of Internal Revenue is now claiming that the method employed by the Wendell Bank does not clearly reflect the income for the period ending May 10, 1952. We do not concede that he is correct in that determination. Assuming, however, for the moment, that the method employed by the Wendell Bank did not clearly reflect the income of the bank for the tax year involved, then the authority of the Commissioner of Internal Revenue under 26 U.S.C.A. (Internal Revenue Code, 1939) Sec. 41, is to compute the income according to some other "method," being a method which in the opinion of the Commissioner does clearly reflect the income.

We urge that the Commissioner has no authority under the aforesaid section of the Internal Revenue Code or any other section to make any computation of the income of the Wendell Bank other than according to a recognized "method" of accounting. U.S. Treasury Regulation 111, Sec. 29.41-2. Basically, the two recognized "methods" are the cash basis method and the accrual basis method. *Huntington Securities Corporation v. Busey, supra.* Thus, still assuming that the cash basis method did not "clearly reflect income" of the Wendell Bank for the period involved, the Commissioner could only change the bank to the "accrual method" for the period involved. See *Security Flour*

Mills Company v. Commissioner of Internal Revenue, 321 U.S.281, 88 L.Ed. 725, 64 S.Ct. 596 (1944), wherein the Supreme Court of the United States clearly recognized the proposition that neither the Commissioner nor the taxpayer can substitute a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system. At pages 285 and 286, the Supreme Court further stated the following to be the well understood and consistently applied doctrine:

> " . . . Cash receipts on matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

The recent case of *Waldheim Realty and Investment Company v. Commissioner,* 245 F.(2d) 823 (8th Cir., 1947), follows the ruling of the Supreme Court that a hybrid basis of accounting is not permitted and prohibited the Commissioner from applying an accrual basis of accounting to a portion of the expenses of a cash basis taxpayer.

In making such a change, the Commissioner must, of course, accrue all items of expense and deductions as well as all items of income on the accrual basis in the income tax return for the close of the tax period in-

volved. See particularly the second sentence of U.S. Treasury Regulation 111, Sec. 29.41-2, which states:

> " . . . A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency . . . "

In addition, for the change to the "accrual method" to clearly reflect the income of the bank for the period involved, it is well settled that the Commissioner must place the bank on an accrual basis as of the beginning of the period involved. 3 CCH 1958 Stand. Fed. Tax Rep., Para. 2982.05. Then, only by this change of method could the Commissioner properly urge that the accrual method which he adopted "clearly reflected income" for the period involved.

The limitation of the right of the Commissioner with respect to the method of computing income, set forth in 26 U.S.C.A. (Internal Revenue Code, 1939) Sec. 41, was for the purpose of preventing the distortion of income such as is produced by the actions of the Commissioner in connection with the Wendell Bank. The Wendell Bank should pay an income tax for the tax period involved based on a method of accounting which clearly reflects income. Either a true cash basis of accounting for the year or an accrual basis of accounting for the year, as above set forth, would "clearly reflect income."

When the Commissioner endeavors, however, to accrue interest on notes held by the Wendell Bank, where the interest has not yet been paid to the bank before the

end of the tax year involved, he is distorting the income of the bank and not computing it in accordance with any "method" of accounting. For example: Items of interest which had accrued at December 31, 1951, are included by the Commissioner in the income of the Wendell Bank for the year commencing January 1, 1952, and ending May 10, 1952. Further, unpaid accrued expenses at the date of liquidation were not deducted (Tr. 19, 26).

3. Summary of argument that the Wendell Bank properly reported its income and the Commissioner erred in including accrued interest in the final income tax return of the Wendell Bank.

To summarize this portion of the argument, it is our position:

(1) That the Wendell Bank was on a consistent and established cash basis of accounting for income tax purposes which clearly reflected income and which had never been challenged by the Internal Revenue Service, and that it was required therefore to file its final income tax return upon the same basis.

(2) That in the event the cash basis did not clearly reflect the income of the Wendell Bank, then the Commissioner of Internal Revenue has authority to change the accounting basis to the "accrual basis" for the period involved. In making the change to the accrual basis, all items of income and all items of expense and deductions must be accrued at the close of the preceding tax period, December 31, 1951, and at the close of the final tax period, May 10, 1952, and the income computed

under the accrual basis of accounting for the tax year involved.

(3) That it is beyond the power of the Commissioner to single out accrued interest on loans as of May 10, 1952, and arbitrarily add that item to income because this inconsistency produces a distortion of income and makes the accounting for the Wendell Bank for its final tax year on a basis other than a recognized "method of accounting," to-wit: either the cash basis or the accrual basis.

B. Answer to Argument That Some Interest on Notes Held by Wendell Bank Is Not Reported as Income

On May 10, 1952, the Wendell Bank was completely dissolved by the distribution of a liquidating dividend to the stockholders of the bank (Tr. 25). The corporation retained no assets after that date. Under U.S. Treasury Regulation 111, Sec. 29.52-1, the corporation is not in existence after May 10, 1952, even though it may continue as a corporation for certain limited purposes such as for the purpose of suing and being sued. Certainly in promulgating the regulations, the Commissioner of Internal Revenue had in mind that the liquidating corporation might be either on the cash basis or the accrual basis of accounting.

There is no hint in the regulations that such a corporation be required, in its final year, to change its method of accounting. Thus, it must have been known by the Commissioner of Internal Revenue that a cash basis corporation might distribute all of its assets and close

its taxable year. It must have been contemplated by the Commissioner that there would be accrued interest and accrual items of every kind, both income and expense, upon the books of such a liquidating corporation which was on the cash basis.

Presumably, the regulation could have provided that the corporation would continue in existence for tax purposes, if it were on the cash basis, until such time as the accrued items of expense had been paid and the accrued items of income had been received. However, U.S. Treasury Regulation 111, Sec. 29.52-1 provides to the contrary. Therefore, it is our position that after the liquidation of a cash basis taxpayer the stockholder or stockholders receiving the distribution must report on their income tax returns all of the income received by them after the date of dissolution. In this case the sole stockholder, at the time of dissolution, was the Appellant, The Idaho First National Bank.

For example, if the Wendell Bank on September 10, 1951, had made a loan of $100.00, taking a promissory note due in one year with interest at the rate of 6% per annum, the following tax consequences would apply:

(1) There would be no income shown by the Wendell Bank at December 31, 1951, on the note, since the Wendell Bank was on the cash basis of accounting.

(2) There would be no income shown by the Wendell Bank in its final tax return for the period ending May 10, 1952, because it remains on the cash basis of accounting.

(3) When the stockholder of the Wendell Bank, who received a distribution of the note on May 10, 1952, collected $106.00 on September 10, 1952, the stockholder would have to report as income $6.00.

(4) In the event that the contention of the Government is sustained, and the Wendell Bank must report as income the $4.00 which had accrued as interest on the note by May 10, 1952, then the stockholder would be given a basis of $104.00 in the note and would only have to report as income on September 10, 1952, the sum of $2.00.

(5) Even if the contention of the Commissioner should be sustained that the cash method of accounting does not clearly reflect the income of the Wendell Bank for the period ending May 10, 1952, the Commissioner must put the bank on a recognized method, the accrual method of accounting. Upon this method it should be permitted to reflect as income for the period from January 1 to May 10, 1952, only that portion of the $4.00 total interest accrual on the note by May 10, 1952, which accrued after January 1, 1952, or the sum of $2.17. We submit that this handling of the situation would, however, give a basis of $104.00 to the stockholder, who then would have to report as gross income only the $2.00 additional when he received payment of $106.00 on September 10, 1952.

(6) In the event the Commissioner is successful in putting the Wendell Bank upon the accrual basis, the $1.83 of interest accrued at December 31, 1951, would

be subject to tax in the year 1951 if the Commissioner put the Wendell Bank on the accrual basis for that year.

Thus, it is apparent that under any handling of the situation the entire $6.00 will be reported as a part of the gross income of some taxpayer. The argument that some of the accrued interest in the case of the Wendell Bank would not be reported as income by any taxpayer we submit is in error.

C. Conclusion

In conclusion, it is submitted that:

(1) The District Court judgment should be reversed and the final income tax return of the Wendell Bank should be permitted to stand upon its present basis, computed upon the cash receipts and disbursements method of accounting.

(2) That if the Commissioner has demonstrated that the cash basis does not clearly reflect income of the Wendell Bank for the period involved, he must put the bank upon a recognized method of accounting other than the "cash basis," and this means that he must put it upon the "accrual basis" for the tax period involved. Putting the bank upon the accrual basis means that income, expense and deductions must be reflected in the final year based upon the increase or decrease from those accruals existing at the beginning of the period. Otherwise, the accrual method selected by the Commissioner would "not clearly reflect income" for the period

involved, but would on the contrary result in a gross distortion of income.

It is respectfully submitted by the writers of this brief that the decision of the District Court should be reversed and that judgment should be entered in favor of the appellant in accordance with the prayer of its complaint.

Respectfully submitted,

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